Nonfamily Managers, Family Firms, and the Winner's Curse: The Influence of Noneconomic Goals and Bounded Rationality

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Chrisman, J.J., **Memili, E.**, & Misra, K. 2014. Non-family managers, family firms, and the winner's curse: The influence of non-economic goals and bounded rationality. *Entrepreneurship Theory and Practice,* 38(5), 1103-1127

Abstract:

We explain why family-centered noneconomic goals and bounded rationality decrease the willingness and ability of small- and medium-sized family firms to hire and provide competitive compensation to nonfamily managers even in a labor market composed of stewards rather than agents. Family-centered noneconomic goals attenuate the ability to attract high-quality, nonfamily managers by promoting inferior total compensation packages, fewer opportunities for advancement, idiosyncratic strategies, and higher performance expectations. Furthermore, bounded rationality limits nonfamily managers' ability to meet performance expectations when hired. The result is the "winner's curse," where neither the economic nor noneconomic goals of family owners are fully achieved.

Keywords: family | firms | noneconomical | nonfamily managers | bounded rationality

Article:

Introduction

The limited ability and willingness of family firms to compete in the market for managerial labor (Carney, 2005; Gedajlovic & Carney, 2010; Schulze, Lubatkin, Dino, & Buchholtz, 2001; Sirmon & Hitt, 2003; Verbeke & Kano, 2010), as well as the differences in the compensation practices of family and nonfamily firms (Combs, Penney, Crook, & Short, 2010; Ensley, Pearson, & Sardeshmukh, 2007; Gomez-Mejia, Larraza-Kintana, & Makri, 2003; McConaughy, 2000; Park, 2002), have been frequently discussed. [1] Prior work suggests that the competitive disadvantages of family firms in the managerial labor market and the seemingly irrational behavior of hiring less capable family managers largely stem from a desire to minimize agent opportunism and maximize the achievement of family-centered, noneconomic goals associated with maintaining family control of the firm and behaving altruistically toward family members (Burkart, Panunzi, & Shleifer, 2002; Chua, Chrisman, & Bergiel, 2009; Ilias, 2006; Lee, Lim, & Lim, 2003). [2] However, some scholars argue that in many situations, stewardship theory rather than agency theory better characterizes family firms (Corbetta & Salvato, 2004). If so, the relationship between family owners and nonfamily managers needs to be reconsidered because stewardship theory provides an alternative conceptualization of cooperative relationships that depend on collectivistic rather than individualistic motives (Davis, Schoorman, & Donaldson, 1997).

However, the efforts of stewards, as well as those of agents and owners, are bounded by imperfect and asymmetric information (Jensen & Meckling, 1976, 1994; Simon, 1945). Bounded rationality implies that there are limits to the ability of stewards to align their interests with those of the organization, as well as limits to the ability of owners to properly evaluate the pro-organizational intentions, abilities, and actions of stewards. The validity of the bounded rationality argument is well understood, yet no one has attempted to consider how, in conjunction with family-centered, noneconomic goals, it influences the hiring and compensation decisions of family owners with respect to nonfamily managers who might behave as stewards. Indeed, if bounded rationality is important, the precontractual conditions and expectations of nonfamily managers and family owners may take on a heightened significance even if the threat of opportunism is eliminated or reduced. By focusing on situations where stewardship operates, how those conditions and expectations influence behaviors can be better understood.

The purpose of this paper is, therefore, to explain why family-centered, noneconomic goals and bounded rationality decrease the willingness and ability of small- and medium-sized family firms to hire and provide competitive compensation to nonfamily managers, even if those managers are more talented than available family managers and the labor market is composed of stewards rather than agents. [3] We will show how these issues are interrelated by discussing the supply and demand sides of the managerial labor market as it concerns family firms. Furthermore, while previous discussions have assumed, rightly, that family firms based their decisions regarding the hiring and compensation of nonfamily managers on the particularistic pursuit of family-centered, noneconomic goals that create socioemotional wealth (Carney, 2005; Chua et al., 2009; Schulze et al., 2001), we argue that there is also an underlying economic rationale for such decisions that has nothing to do with agent opportunism. Since family and nonfamily firms must compete and bid for talent in the managerial labor market, we draw upon economic utility and bidding theories (Hicks, 1939; Thaler, 1988) in our analysis. We focus on small- and medium-sized firms because, as explained below, firm size can affect the nature of the hiring and compensation decisions of family firms.

This paper contributes to the family firm literature by discussing the economic and noneconomic factors that influence the participation of small- and medium-sized family firms in managerial labor markets. On the supply side, our analysis shows that the family-centered, noneconomic goals of family firms lead to human resource policies in regard to hiring, compensation, and promotion that limit the available pool of management talent, creating a “lemons” problem (Akerlof, 1970) that stewardship cannot eliminate. [4] Our analysis also suggests that bounded rationality, noneconomic goals, and the tendency to follow idiosyncratic strategies create uncertainties that contribute to the reluctance of nonfamily managers to work in family firms. Thus, stewards as well as agents prefer to work for firms that they perceive to be compatible with their interests, and pro-organizational behavior with respect to a specific firm cannot exist prior to the consummation of the employment contract (Jensen & Meckling, 1994).

On the demand side, we show how trade-offs between economic and noneconomic goals can lead to higher performance expectations for nonfamily managers in family firms relative to the performance expectations for both (1) family managers in family firms and (2) nonfamily managers in nonfamily firms. This comes about because hiring a nonfamily manager usually means giving up noneconomic goals to achieve economic goals. [5] However, the economic concept of diminishing marginal utility suggests that family owners should be willing to give up less and less of a desired noneconomic benefit to obtain more and more of a desired economic benefit if the same level of utility is to be maintained (Hicks, 1939; Marshall, 1890). This well-known concave utility function (i.e., a nonlinear, inverted U-shape function) means that achievement of economic goals increases utility at a decreasing rate (movement to the right along the inverted U-shape function), and that the sacrifice of noneconomic goals decreases utility at an increasing rate (movement to the left along the inverted U-shape function). Thus, assuming the ability of an individual manager is fixed in the short term, there is an increasing probability that as family-centered, noneconomic goals become more important, the performance improvements generated by employing nonfamily managers will be lower than the performance expectations of family owners. The probability that performance expectations will not be achieved will further increase if the family firm follows an idiosyncratic strategy, owing to the bounded rationality of nonfamily managers. This “winner's curse”—overbidding or overpaying for nonfamily managers relative to their ability to contribute to firm goals (Capen, Clapp, & Campbell, 1971; Thaler, 1988)—suggests that family owners are more likely to maximize their utility by hiring family managers even though hiring nonfamily managers might lead to higher economic performance.

In short, this paper contributes to the literature by providing a new perspective on the precontractual employment decisions of family owners as well as nonfamily managers. We do this by relaxing the standard assumption about opportunism and replace it with an assumption of stewardship. This allows us to focus on how the attempts of family owners to maximize the joint utilities associated with economic and noneconomic goals in the context of bounded rationality affect the hiring and compensation of nonfamily managers. We thereby show that family owners do not act irrationally, and that neither agent opportunism nor noneconomic goals alone provide sufficient explanations for their reluctance to hire nonfamily managers.

Boundaries and Assumptions

Before proceeding further, we must discuss our focus on small- and medium-sized family firms, and the boundary conditions and assumptions of our theoretical model. Following that, we describe supply-side considerations in the managerial labor market, which are dependent on the employment preferences of managers. Later in this paper, we will discuss the preferences of family owners that drive demand-side considerations.

We focus on small- and medium-sized family firms because such firms are apt to face starker trade-offs in choosing between family and nonfamily managers, and therefore are better suited to illustrate the theoretical perspectives that we wish to emphasize. First, in such firms, the family will typically hold a majority ownership stake rather than simply a so-called controlling interest, as would be the case in large firms. Consequently, their decision-making discretion is greater (Carney, 2005), which also suggests that acts that might dilute that stake are potentially more significant. Furthermore, small- and medium-sized firms tend to be owner-managed, which means that a family member will typically hold the position of chief executive officer (CEO). Likewise, the management team (including the CEO) will typically be smaller and the types of responsibilities of these managers broader than in large firms (Cromie, Stephenson, & Monteith, 1995), in the sense that the top management team will often also undertake the roles and functions of middle and lower managers. Thus, maintaining family control of ownership and management is likely to be of greater concern in such organizations. However, in keeping with our focus on small- and medium-sized firms, we assume that family owners can choose between hiring from within or outside the family to fill management positions in the firm. In other words, we assume that there are family members available, and that the firm is not so large that hiring nonfamily managers is nevertheless required. Family firms are heterogeneous (Melin & Nordqvist, 2007), and as shall be discussed later, if hiring nonfamily managers becomes necessary for firm sustainability, the framing of the decision will be altered. Therefore, we limit our discussion to small- and medium-sized firms with families large enough to meet immediate managerial requirements. We also assume that the larger pool of nonfamily managers available in the labor market means that there are nonfamily managers who are more capable than family members.

Second, a central assumption of the family business literature and of this paper is that the pursuit of family-centered, noneconomic goals that flow from family involvement and influence in a firm is a key factor distinguishing family and nonfamily firms (Chrisman, Chua, & Sharma, 2005) because such goals tend to lead to strategies and behaviors that are idiosyncratic in nature (Carney, 2005). The achievement of these goals leads to the creation of socioemotional wealth, and includes, among other things, the preservation of family values, harmony, social capital, and reputation, as well as the ability to behave altruistically toward family members (Chrisman, Chua, Pearson, & Barnett, 2012; Gómez-Mejía, Haynes, Núñez-Nickel, Jacobson, & Moyano-Fuentes, 2007; Pearson, Carr, & Shaw, 2008). The accomplishment of these goals is dependent upon the family's control of the firm, and the importance of these goals increases the desirability of maintaining family control.

Gómez-Mejía et al. (2007) show that a desire to preserve socioemotional wealth may cause family firms to accept or avoid risk to their economic performance. They attribute this to family owners' being loss-averse with respect to their socioemotional wealth. In the general case, this leads family firms to follow risk-averse strategies in order to protect socioemotional wealth, but when firm performance is below aspirations, socioemotional wealth will sometimes be sacrificed to improve performance (Gomez-Mejia, Makri, & Larraza-Kintana, 2010). These findings suggest that family firms are concerned with the trade-offs between economic and noneconomic goals that are necessary to maximize their overall utility. Consequently, we posit that they will react according to which utility they perceive to be threatened.

Third, with regard to utilities, we assume that family owners will attempt to order their activities in such a way that their overall utility is maximized through the firm's achievement of economic and noneconomic goals, but marginal utility diminishes as more of a particular goal is achieved (Hicks, 1939; Marshall, 1890). By this, we mean that whenever there is a trade-off among goals, each additional unit of a desired goal will be less valuable than the previous unit because, given finite resources, the attainment of one goal reduces the ability to attain another desired goal. Thus, achieving more and more of a goal will increase utility, but the increase will occur at a decreasing rate. In other words, since individuals will be willing to give up less and less of one goal to obtain more and more of another, marginal utility increases at a decreasing rate when a goal is achieved, but declines at an increasing rate as goal achievement decreases.

Fourth, we assume that nonfamily managers are stewards who maximize utility by aligning their goals with those of the firm and its principals (Davis et al., 1997). Both agency and stewardship theories are concerned with cooperative relationships among individuals. However, these theories have different assumptions regarding those relationships. Agency theory deals with conflicting goals and information asymmetries between principals and agents, and how the associated costs can be controlled through incentive and monitoring systems (Eisenhardt, 1989). In contrast, stewardship theory draws on sociopsychological perspectives to study relations in organizations where members are collectivists in the sense that they value cooperative behaviors more than behaviors driven by self-interest (Davis et al.). Accordingly, the individuals' interests tend to be aligned with the interests of the organization, which would suggest that “pro-organizational collectivistic behaviors have higher utility than individualistic self-serving behaviors” (Davis et al., p. 24). Hence, stewardship approaches to the study of family firms might be particularly relevant, as family firm members may value family firm objectives more highly than their individual objectives (Corbetta & Salvato, 2004).

If stewardship theory holds, there should be no conflict of interest between family owners and nonfamily stewards. The latter will not behave opportunistically by shirking, consuming perks, or otherwise following policies that contradict the goals of the owners of the firm. Likewise, even though stewardship theory is silent on how individuals will behave prior to joining an organization, we assume that stewards will not intentionally misrepresent their abilities, and therefore that issues of adverse selection are confined to those related to information asymmetries rather than dishonesty. However, since stewardship only comes into play after the employment contract is consummated, we follow Jensen and Meckling (1994) in assuming that individuals will seek to attach themselves to organizations that they perceive as the most compatible with their own intrinsic and extrinsic needs and aspirations.

Finally, we assume that both owners and stewards are boundedly rational (Simon, 1945). By this, we mean that they attempt to act in a manner that will lead to the achievement of their goals (which later become aligned with the firm that hires them), but their ability to do so is bounded because they possess imperfect information and imperfect ability to process that information. In the context of the interactions and collaborations between owners and stewards, this suggests that they possess asymmetric information. Incomplete and asymmetric information is expected to lead to uncertainty with regard to the outcome of those interactions and collaborations, even when both parties behave in good faith. [6] Thus, as shall be illustrated below, adverse selection occurs when family firms enter the market for managerial labor in spite of the absence of opportunism because asymmetric information and sorting based on self-interest (but not self-interest seeking with guile) creates a lemons market where differences in the quality of nonfamily managers are difficult to detect and inferior applicants dominate the available labor pool.

Supply Consideration

On the supply side of the managerial labor market, dissemination of information leads workers and employers to be sorted or matched according to their attributes (Becker, 1973; Williamson, 1990). Nonfamily managers use their social networks and other sources of information to search for available managerial positions. They assess attractiveness by comparing their direct knowledge about specific employers and their knowledge about classes of employers with their goals, preferences, and expectations (Klein & Bell, 2007; Krueger & Schkade, 2008; Miyazaki, 1977). To aid in this process, employers engage in signaling by providing information about the company and the position (Spence, 1973). Evidence suggests that managers are sorted, in part, by ability (Thaler, 1989), and therefore similar to high-quality employers, high-quality managers have an incentive to signal their ability in order to obtain more attractive and better paying positions (Albrecht & Vroman, 2002; Miyazaki; Spence). As a result of the sorting process, the average expected ability of job candidates from the pool of applicants for a higher paying position will be greater than that of job candidates for a lower paying position (Weiss, 1980).

Nevertheless, and in contrast to economic theory (Thaler, 1989), the major source of differences in compensation among individuals in a given occupation is related to interindustry and firm-level variations (Groshen, 1991; Levy & Murnane, 1992). In the case of family firms, it is well established that owing to the desire to maintain family control and behave altruistically toward family members, advancement opportunities for nonfamily managers are more limited compared with those of family managers, and nonfamily managers in nonfamily firms (Poza, Alfred, & Maheshwari, 1997; Schulze et al., 2001; Verbeke & Kano, 2010, 2012). Family firms are also reluctant to offer stock options or otherwise share the ownership of the firm with nonfamily managers, again because by doing so they reduce family control and involvement (Gedajlovic & Carney, 2010; McConaughy, 2000; Park, 2002).

If the expectation of future income through firm ownership and career advancement is a factor in the managerial labor market, family firms will be at a disadvantage in hiring nonfamily managers unless they adjust the total compensation package they offer by paying higher current wages in the form of salary, bonuses, and profit sharing to make up for lower future income-earning opportunities. [7] This is consistent with the work of Gibbons and Murphy (1992), who show that compensation contracts should optimize the total compensation package. Therefore:

- **Proposition 1:** To attract high-quality, nonfamily managers, small- and medium-sized family firms with intentions to maintain family control of firm ownership and management will need to offer higher current wages than small- and medium-sized, nonfamily firms in order to offset lower future income-earning opportunities within the firm.

However, even if differences in current wages and future income-earning opportunities between family and nonfamily firms do not exist, the extent to which family firms pursue family-centered, noneconomic goals beyond simply preserving family control will aggravate bounded rationality problems and lead nonfamily managers to prefer to work for nonfamily firms. In other words, whereas a family's desire to maintain control has the potential to unfavorably alter the rewards available to managers from the successful discharge of their duties, the pursuit of family-centered goals may unfavorably alter their probability of being successful. As explained below, to the extent that this occurs, family firms will be less desirable employers.

Family-centered, noneconomic goals are harder to define and measure, meaning they are harder to communicate before or after a nonfamily manager takes a position with a family firm (Chua et al., 2009; Sirmon & Hitt, 2003). Therefore, even stewards will be hesitant to align themselves with family firms because neither their intrinsic nor extrinsic motivations are likely to be attained if asymmetric information makes goal alignment and achievement more difficult. Second, noneconomic goals are even more likely to vary among firm owners than economic goals (Schulze et al., 2001), which will further increase uncertainty and leave stewards little alternative but to concentrate on the economic goals of the firm (Davis et al., 1997). Given that stewards will select employers based on compatibilities that allow them to maximize utility, nonfamily firms that possess only or primarily economic goals would then represent a more desirable option. Third, family-centered, noneconomic goals are likely to be associated with idiosyncratic strategies (Carney, 2005; Lee et al., 2003), which can amplify the uncertainties associated with the achievement of economic goals (not to mention noneconomic goals), as well as inhibit efficient sorting (Moscarini, 2005; Williamson, 1990).

These factors increase the *risk* of managerial failure, owing to bounded rationality (Lee et al., 2003). Furthermore, the idiosyncratic knowledge obtained working in family firms may be difficult to transfer to other contexts at a later date, extending to some extent the so-called family handcuff (Gomez-Mejia et al., 2003) to nonfamily managers. Finally, since nonfamily managers are often treated as scapegoats when family firms fail to fulfill their economic aspirations (Gomez-Mejia, Núñez-Nickel, & Gutierrez, 2001), the *costs* of managerial failure increase as well.

To be willing to bear these risks and costs, we reason that nonfamily managers would expect to receive higher total compensation as compared with situations where such risks and costs are absent or lower (i.e., in nonfamily firms). Therefore, as stated below, we reason that high-quality managers will demand higher total compensation (current wages plus future income-earning opportunities) as recompense for the risk and costs they must incur in a family business setting, rather than just higher current wages to offset lower future income-earning opportunities.

- **Proposition 2:** To the extent that small- and medium-sized family firms pursue idiosyncratic strategies and family-centered, noneconomic goals beyond simply maintaining family control, they will need to offer higher total compensation (current wages plus future income-earning opportunities) than small- and medium-sized, nonfamily firms to attract high-quality, nonfamily managers.

Nevertheless, lower paying positions that offer nonpecuniary benefits, such as more attractive work environments, can offset pay differentials for workers whose utilities are maximized by that combination (Duncan & Holmlund, 1983; Hwang, Reed, & Hubbard, 1992). Family firms have been suggested to offer greater collegiality, employee care, and loyalty, less bureaucracy, better job security, and more flexible work practices than nonfamily firms (Block, 2011; Habbershon & Williams, 1999; Klein & Bell, 2007; Memili, Eddleston, Zellweger, Kellermanns, & Barnett, 2010; Poza et al., 1997). Therefore, nonfamily managers can choose between nonfamily firms that offer greater future income-earning opportunities and family firms that offer a better working environment. A better working environment appeals to everyone and requires no special skills. However, by definition, future income-earning opportunities require greater ability, which higher quality managers are more likely to possess than lower quality managers. Furthermore, the ability and willingness to pursue opportunities that demand exceptional ability tend to be correlated, suggesting that positive sorting in the labor market will occur (Becker, 1973; Chua et al., 2009; Miyazaki, 1977). This reasoning, in conjunction with our above discussion, indicates that the pool of managers available to nonfamily firms will be of higher average quality than the pool of managers who seek employment in family firms (cf. Albrecht & Vroman, 2002) even if the noneconomic benefits available to nonfamily managers are greater in family firms. Again, we note that prior to accepting employment, even stewards will base their choice of where to work on which employer offers them the greatest opportunity to maximize their utilities, and that calibrating economic goals is not as difficult as calibrating noneconomic goals under conditions of imperfect and asymmetric information. This leads us to conclude that although high-quality stewards may be willing to work in family firms, their utilities are more likely to be maximized through employment with firms that focus on economic goals, and are willing and able to offer a total compensation package that is commensurate with the manager's ability. Thus, we propose:

- **Proposition 3:** The average capabilities of the pool of nonfamily managers who are attracted to work in small- and medium-sized family firms will tend to be lower than the average capabilities of the pool of nonfamily managers who are attracted to work in small- and medium-sized, nonfamily firms.

Demand Considerations

Up to this point, we have discussed the supply-side dynamics facing small- and medium-sized family firms in hiring and compensating nonfamily managers. However, the demand side of the coin potentially plays an even more crucial role in their employment and compensation decisions. In family firms, the desire to employ family managers is well known (e.g., Chua et al., 2009; Karra, Tracey, & Phillips, 2006). However, many family firms also seek to employ nonfamily managers to avoid inertia in strategic decision making (Mitchell, Morse, & Sharma, 2003; Schulze et al., 2001), prevent managerial entrenchment (Gomez-Mejia et al., 2001), and improve the quality of the management team (Chua et al.; De Massis, Chua, & Chrisman, 2008; Dunn, 1995). Attracting and retaining capable nonfamily managers may also be essential for firm growth and the institution of professional management practices (Klein & Bell, 2007; Sirmon & Hitt, 2003; Stewart & Hitt, 2012). As we have discussed above, family firms need to provide an attractive package of wage compensation and future income-earning opportunities to attract and retain high-quality managers. However, as we will explain below, family firms may be reluctant to do so, owing to their family-centered, noneconomic goals, such as providing jobs for family members (Chrisman, Chua, & Zahra, 2003). When providing jobs and promotions to family members is the norm, family members may be placed in key positions even if there are more capable nonfamily managers for such positions (Carney, 2005; Dyer, 2006). As Perrow (1972) explains, family firms often place more value on kinship ties than competence in choosing and promoting employees. Thus, as long as there are family members available to fill management positions in family firms, nonfamily managers might not be considered even if they possess superior capabilities. As noted above, this is because hiring nonfamily managers reduces the family's control of the firm, its ability to act altruistically to family members, and thus its socioemotional wealth (e.g., Gómez-Mejía et al., 2007, 2010). [8]

In addition, family involvement might have distinctive consequences for the compensation system of family firms (Ensley et al., 2007). For example, a performance-based compensation system may be inconsistent with the desire to distribute benefits equally among family members (Chua et al., 2009). Furthermore, the compensation of family managers may place bounds on the compensation paid to nonfamily managers even if the latter displays greater ability (Chua et al.). These considerations may negatively affect the willingness of family firms to provide competitive compensation to nonfamily managers.

To explain the compensation decisions of small- and medium-sized family firms competing with nonfamily firms in hiring managers, we assume that the supply of managers is finite and that each firm will exert effort to hire managerial talent (Bognanno, 2001; O'Keeffe, Viscusi, & Zeckhauser, 1984). The utility for firm owners associated with hiring a manager is dependent upon the extent to which that manager contributes to the achievement of the owners' goals. As suggested above, we assume that nonfamily firms are driven solely or primarily by economic goals, whereas a family firm is expected to take into account a more balanced set of economic and noneconomic goals, which can vary in importance. Regardless, both types of firms attempt to maximize utility based upon the attainment of their goals.

For both family and nonfamily firms, utility is increased as economic goal attainment increases. Economic goal attainment is represented by the firm's net income or profit, which for simplicity is modeled as the difference between the firm's gross income and the current wages paid to its managers. Following Weiss (1980), we assume that the wages of managers are an increasing function of their productivity rather than equal to their productivity. By this, we mean that firms with more qualified managers will obtain higher gross incomes and will pay their managers higher wages than firms with less qualified managers, but that the higher wages paid to better qualified managers will not necessarily consume the entire increase in gross income that those managers generate. In other words, we allow for positive and increasing net incomes in our model. Thus, if paying higher wages attracts higher quality managers, the utility of family as well as nonfamily owners should increase.

However, the utility of the owners of family firms (but not of the owners of nonfamily firms) is also affected by the achievement of family-centered, noneconomic goals, which in our model represents the difference between the socioemotional benefits and socioemotional costs (Astrachan & Jaskiewicz, 2008) associated with the employment of family and nonfamily managers. In general, employing family managers in the firm should increase family owners' utility because it enhances the family's control over firm decision making, and allows them to fulfill their obligations and altruistic impulses toward family members (cf. Gómez-Mejía et al., 2007; Karra et al., 2006; Schulze et al., 2001). Conversely, employing nonfamily managers should typically reduce the noneconomic utility of family owners, owing to a loss of family control and family involvement (Gedajlovic, Lubatkin, & Schulze, 2004). Although there might be unusual circumstances where nonfamily management would generate noneconomic benefits for family owners (e.g., by minimizing conflicts that might ensue if forced to pick between two family members contending for the same position), these benefits would need to be greater than the noneconomic costs of reducing family control and involvement. Furthermore, as noted above, even nonfamily stewards are unlikely to make significant contributions to the achievement of noneconomic goals of family owners because of incomplete and asymmetric information. [9]

Since the baseline condition in family firms should be the employment of family managers, we consider how a switch to the employment of nonfamily managers will affect the utility of family owners. First, assuming that nonfamily managers have a positive impact on economic goal achievement, the utility of family owners would increase. However, this increase must be weighed against the loss in utility if employing nonfamily managers reduces the attainment of family-centered, noneconomic goals. Given diminishing marginal utility, the increases in economic performance associated with the employment of nonfamily managers will only increase the utility of family owners at a decreasing rate (Hicks, 1939; Marshall, 1890). On the other hand, the decrease in socioemotional wealth associated with hiring nonfamily managers will reduce utility at an increasing rate, depending upon the importance of noneconomic goals. Therefore, the employment of a nonfamily manager of a given quality at a given wage rate will always yield a lower utility for owners of family firms than for owners of nonfamily firms who experience no offsetting declines in utility from a loss of socioemotional wealth. Furthermore, the net change in utility from hiring a nonfamily manager is likely to be negative for family owners for two reasons. First, family owners are loss-averse with respect to their socioemotional wealth, which means that any decrease in the ability to achieve noneconomic goals is likely to be felt much more strongly than the increase in the ability to achieve economic goals. Second, as discussed above, because family firms tend to restrict promotion opportunities and are reluctant to provide stock options to nonfamily managers, they must offer higher current wages than nonfamily firms to attract high-quality, nonfamily managers. But higher wages would reduce net incomes and decrease the economic utility of hiring high-quality, nonfamily managers. Thus, if family owners are utility maximizers, the following proposition must follow:

- **Proposition 4:** As the importance of family-centered goals increases, the willingness of small- and medium-sized family firms to pay higher current wages to attract high-quality, nonfamily managers will decrease.

Moving beyond the micro-level demand factors for managerial talent, another force that must be reckoned with is the number of firms in the relevant labor market that are seeking to hire managers. Family and nonfamily firms compete with each other to hire talent. As the number of firms competing for managerial talent increases, managerial compensation should rise and net income should fall for all firms, assuming that the supply of managerial labor is constant, or at least does not increase commensurate with the increase in demand (Bognanno, 2001;

Eriksson, 1999; Main, O'Reilly, & Wade, 1993; O'Reilly, Main, & Crystal, 1988). This would decrease the marginal utility of all firms. However, since the marginal disutility associated with a decline in socioemotional wealth would be unaffected, higher wages would increase the likelihood of a net decline in overall utility for owners of family firms relative to nonfamily firms. Thus, as the competition for managers goes up, we expect family firms to be less rather than more willing to offer higher wages to nonfamily managers than nonfamily firms. [10]

- **Proposition 5:** As competition in the market for managerial labor increases, the willingness of family firms to pay wages sufficient to hire high-quality, nonfamily managers will decrease.

The Winner's Curse

In the managerial labor market, job candidates receive bids from employers for their services (Joiner,2005). The perceived value of a candidate to an employer is reflected in the compensation, which is the bid for the talent. As defined earlier, the winner's curse results when a firm wins the recruiting competition for managers by overbidding relative to the contribution that those managers make toward goal achievement (Thaler, 1988). Thus, the winner's curse arises whenever the victors find that by winning they actually lose (i.e., the costs exceed the benefits).

Several studies from experimental and nonexperimental settings have examined the process of recruitment as an auction, and demonstrate that the winner's curse arises when a bidder fails to accurately estimate the actual value of the manager (e.g., Harrison & List, 2007). Accuracy is difficult under conditions of bounded rationality. Incomplete and asymmetric information leads to uncertainty concerning the manager's productive ability and the minimum bid needed to counter the offers of other potential employers (Gibbons & Katz, 1991; Perri, 1995). Furthermore, bids are signals, and even when the signaler does not intend to deceive, bounded rationality can cause signals to be misleading (cf. Spence, 1973). For example, competitors may overestimate the talents of a manager and bid accordingly. These bids, in turn, could affect the estimates and bid of the focal firm. Furthermore, unrealistically positive assessments of their skills, plans, and ability to control events (Kahneman & Lovello, 1993) can lead even managers who behave as stewards to send overly optimistic signals about their future performance potential.

Overbidding not only leads to a potential financial setback for the winning firm, but also creates discontent, owing to unmet performance expectations (Joiner, 2005). Family firm owners are more susceptible to both because of their pursuit of noneconomic goals, and bounded rationality. They are likely to experience the winner's curse when hiring nonfamily managers because their compensation and promotion policies reduce the quality of the available labor pool but not necessarily their performance expectations for the managers they do hire. Here, bounded rationality may obscure cause and effect. By contrast, nonfamily firms are likely to pursue compensation (e.g., stock options) and promotion policies (based on merit) that improve the quality of the available labor pool and reduce the probability of the winner's curse. In addition, because of noneconomic goals and strategic idiosyncrasies, family firms may need, but are generally less willing, to pay higher current wages to attract high-quality managerial talent. Finally, hiring nonfamily managers suggests that fewer family managers can be hired, which negatively affects the ability of family owners to achieve their noneconomic goals. By contrast, nonfamily firms without or with fewer noneconomic goals do not face these difficulties.

As we have explained, the utility of family owners is a function of the extent to which economic and noneconomic goals are valued and achieved. Therefore, the utility to family owners relative to nonfamily owners of winning the competition to hire a particular nonfamily manager will become progressively lower as the pursuit of family-centered, noneconomic goals becomes more important to them. Again, this is because the marginal utility of family owners will decline at an increasing rate as noneconomic goals are sacrificed, and the rate of decline will be steeper as the importance of family-centered, noneconomic goals increases. Thus, if family owners wish to maintain or increase their utility, the performance expectations to which nonfamily managers will be held must be higher than would be the case in nonfamily firms where there are no offsetting losses of utility associated with hiring nonfamily managers.

- **Proposition 6:** To the extent that small- and medium-sized family firms pursue family-centered, noneconomic goals, their performance expectations for nonfamily managers will be higher than the performance expectations for nonfamily managers of small- and medium-sized, nonfamily firms.

Likewise, to compensate for the loss of utility, family firms are likely to expect more effort from nonfamily managers than from family managers in order to produce a net income that compensates for the loss of socioemotional wealth. Put differently, if a family firm could hire a family or nonfamily manager for the same compensation, the latter would need to perform at a higher level for the family owner to obtain comparable utility, owing to the cost associated with sacrificing noneconomic goals. Again, this is because economic analysis suggests that the marginal utility of family firm owners (1) will increase at a decreasing rate as the firm gains additional net income from hiring a nonfamily manager, but (2) will also decrease at an increasing rate as noneconomic goals are forsaken by not hiring a family manager. This means that the increase in net income necessary to yield the same utility will be correspondingly greater if a nonfamily manager is hired than if a family manager is hired. Thus:

- **Proposition 7:** To the extent that small- and medium-sized family firms pursue family-centered, noneconomic goals, their performance expectations for nonfamily managers will be higher than their performance expectations for family managers.

The winner's curse is a function of both performance expectations and outcomes. If nonfamily managers are able to produce more and more as the expectations of firm owners become greater and greater, then the winner's curse would not necessarily transpire because the net income of the firm could increase enough to offset losses of noneconomic utility. However, as family-centered, noneconomic goals take on greater significance, family owners are more likely to suffer the winner's curse when hiring nonfamily managers even if the economic performance of the firm is improved. This is a consequence of two factors. First, as we have explained, the potential trade-off between the fulfillment of economic and noneconomic goals (e.g., Chua & Schnabel, 1986) requires economic performance to increase more than noneconomic benefits decrease just to maintain owner utility, let alone increase it. [11] Second, the capabilities of all managers have natural, albeit varying, limits. Combined, we reason that it will be less and less likely that the improvements in economic performance that occur by hiring nonfamily managers will match the expectations of family owners as the importance of noneconomic goals rises. [12] Moreover, the potential for stewardship among nonfamily managers does not ameliorate the situation. Although the pro-organizational tendencies of stewards suggest that they will attempt to work up to their abilities, they remain boundedly rational with finite capabilities.

- **Proposition 8:** As family-centered, noneconomic goals become more important, the likelihood that the performance of nonfamily managers will meet the expectations of family owners will decline.

As discussed above, the pursuit of family-centered, noneconomic goals increases the odds of the winner's curse, owing in part to the finite capabilities of nonfamily managers. As stewards, these managers will attempt to work up to the limits of their capabilities. However, as explained below, the family business context may place constraints on their ability to realize their potential.

Family control gives family owners the discretion to select idiosyncratic strategies and policies, and the pursuit of family-centered, noneconomic goals increases the probability that such idiosyncratic strategies will be followed (Carney, 2005). Unfortunately, nonfamily managers who have gained their experience in more conventional environments may not be able, at least in the short term, to utilize their knowledge, skills, and experience to full effect in family firms (Lee et al., 2003). [13] Indeed, Verbeke and Kano (2010, 2012) emphasize that compared with family managers, nonfamily managers face time compression diseconomies in adjusting to the noneconomic goals and strategic idiosyncrasies of family firms. As a consequence, even stewards may encounter difficulties because being willing to adjust is not the same as being able to adjust. Furthermore, regardless of whether nonfamily managers act as stewards or agents, strategic idiosyncrasies make it harder for family owners to gauge the extent to which nonfamily managers will be able to contribute to firm value. These factors have the combined effect of decreasing the mean and increasing the variance of the performance that can be obtained from nonfamily managers. If the probability of favorable performance outcomes decline and the performance expected for a given wage remains the same, the likelihood of the winner's curse would increase.

Family owners have three potential responses. First, they can offer lower wages to nonfamily managers, which would have a downward influence on performance expectations. However, since nonfamily firms may not follow suit (conventional strategies do not increase the risk of the winner's curse), this response could further attenuate the quality of the pool of managers accessible to family firms. Second, family owners can offer nonfamily managers higher wages. Although higher wages would improve the quality of the labor pool, it would also result in higher performance expectations and would not eliminate bounded rationality. Furthermore, unless higher wages were also paid to family managers, which would reduce firm performance, the decline in noneconomic utility might be even more severe (Chua et al., 2009). Thus, the combined effects of higher performance and higher performance expectations would likely cancel out. [14] Finally, family owners could hire from inside the family. Family owners' lifelong interactions with other family members should reduce uncertainties about their ability to contribute to the firm (Block, 2011; Lee et al., 2003; Sirmon & Hitt, 2003). Hiring family managers also increases rather than decreases socioemotional wealth. For both reasons—lower information asymmetries and positive contributions to noneconomic goal attainment—the probability of the winner's curse will be reduced.

Thus, owing to both economic and noneconomic considerations, small- and medium-sized family firms will prefer, and in fact often be compelled, to hire family managers rather than nonfamily managers. Furthermore, as we have discussed, the idiosyncrasies of the family form of organization serve to exacerbate that preference, even when the risk of appropriation discussed by Lee et al. (2003) is absent. While a preference for family managers in order to achieve noneconomic goals is often viewed as a constraint on the development of human capital in family firms (Barnett & Kellermanns, 2006; Dunn, 1995; Dyer, 2006; Memili & Barnett, 2008; Verbeke & Kano, 2012), this preference also helps them avoid the winner's curse in recruiting managerial talent, and therefore has an economic as well as a noneconomic rationale. Stated formally:

- **Proposition 9:** To the extent that small- and medium-sized family firms pursue family-centered, noneconomic goals and follow idiosyncratic strategies, family owners will prefer to hire family managers in order to increase the ability to achieve their economic and noneconomic goals.

The propositions discussed above are listed in Table 1.

Table 1

Propositions

	Supply considerations
	Current wages and expected future income opportunities
Proposition 1	To attract high-quality, nonfamily managers, small- and medium-sized family firms with intentions to maintain family control of firm ownership and management will need to offer higher current wages than small- and medium-sized nonfamily firms in order to offset lower future income-earning opportunities within the firm.
	Noneconomic goals and total compensation
Proposition 2	To the extent small- and medium-sized family firms pursue idiosyncratic strategies and family-centered, noneconomic goals beyond simply maintaining family control, they will need to offer higher total compensation (current wages plus future income-earning opportunities) than small- and medium-sized nonfamily firms to attract high-quality, nonfamily managers.
	Capabilities of nonfamily managers
Proposition 3	The average capabilities of the pool of nonfamily managers who are attracted to work in small- and medium-sized family firms will tend to be lower than the average capabilities of the pool of nonfamily managers who are attracted to work in small- and medium-sized nonfamily firms.
	Demand considerations
	Family-centered goals and nonfamily managers' current wages
Proposition 4	As the importance of family-centered goals increases, the willingness of small- and medium-sized family firms to pay higher current wages to attract high-quality, nonfamily managers will decrease.
	Competition in the labor market and nonfamily managers' wages
Proposition 5	As competition in the market for managerial labor increases, the willingness of family firms to pay wages sufficient to hire high-quality, nonfamily managers will decrease.
	Winner's curse
	Noneconomic goals and performance expectations
Proposition 6	To the extent that small- and medium-sized family firms pursue family-centered, noneconomic goals, their performance expectations for nonfamily managers will be higher than the performance expectations for nonfamily managers of small- and medium-sized nonfamily firms.
Proposition 7	To the extent that small- and medium-sized family firms pursue family-centered, noneconomic goals, their performance expectations for nonfamily managers will be higher than their performance expectations for family managers.
	Noneconomic goals and the achievement of expected performance
Proposition 8	As family-centered, noneconomic goals become more important, the likelihood that the performance of nonfamily managers will meet the expectations of family owners will decline.
	Strategic idiosyncrasies and family firm hiring preferences
Proposition 9	To the extent that small- and medium-sized family firms pursue family-centered, noneconomic goals and follow idiosyncratic strategies, family owners will prefer to hire family managers in order to increase the ability to achieve their economic and noneconomic goals.

Contingencies

Even though we have outlined a case that appears to have broad generality, the heterogeneity of family firms (Melin & Nordqvist, 2007) suggests that there are a number of important contingencies that should be considered. Therefore, before concluding, we discuss how family size, firm size, and other factors might affect the hiring and compensation decisions of family firms. We focus specifically on firm and family size because, as noted earlier, these can influence the extent to which including nonfamily managers is necessary for firm sustainability, thereby altering how such decisions are framed.

Family Size

We expect that the size of the family will be negatively correlated with the propensity of family firms to hire and provide competitive levels of compensation to nonfamily managers. Simply put, as long as there are family members available, family owners should prefer to hire them for the reasons outlined in this paper (also see Ilias, 2006; Verbeke & Kano, 2012). In general, this means that if the size of the family makes noneconomic goals more important, the expected impact on the supply and demand of managerial labor and the probability of the winner's curse as reflected in our propositions will increase.

On the other hand, as noted above, a lack of availability of qualified family members does not necessarily extinguish the desire to hire family managers. For example, the number of family members available to work in the family firm could be differentially constrained by either a lack of ability or a lack of willingness on the part of some or all of the family members (De Massis et al., 2008). In situations where the competence of some family members is judged deficient, hiring nonfamily managers is expected to be more acceptable than in situations where family members are not willing to join the firm. This is because in the former situation, family owners are able to choose how to maximize their utilities, while in the latter case a potentially desirable alternative is eliminated.

Firm Size

In contrast to the size of the *family*, we expect that the size of the family *firm* will be positively correlated with the propensity to hire and provide competitive levels of compensation to nonfamily managers. When a firm reaches a certain size, decisions must be made on whether overall utility is maximized by ceding partial control over the firm in order to permit continued growth, or limiting growth in order to maintain family control. For example, Ilias's (2006) analysis of the surgical instrument industry in the Sialkot region of Pakistan shows that under extreme conditions, the size of the family firm will be *determined* by the size of the family.

Furthermore, as a firm grows, idiosyncratic knowledge is more likely to be institutionalized in the firm (Lee et al., 2003), making the employment of nonfamily managers less risky from the perspective of employer and employee. However, size and growth are likely to reduce, but not necessarily eliminate, the reluctance of family firms to hire and provide competitive compensation for nonfamily managers as long as family owners pursue family-centered, noneconomic goals. This reluctance appears to be particularly true for top-level positions in the firm (e.g., Bennedsen, Nielsen, Pérez-González, & Wolfenzon, 2007; Lee et al.; Poza et al., 1997). Thus, if firm size decreases the relative importance of the noneconomic goals of family owners, as well as information asymmetries for both family owners and potential nonfamily managers, the supply and demand considerations outlined in this paper and articulated in propositions 1–3 and 4–5, respectively, will be attenuated. Likewise, the probability and potential impact of the winner's curse should also decline in comparison to our contentions in propositions 6–9.

Other Factors

In addition to the size of the firm and the family, there are a number of other contingencies that could influence the policies of a family firm toward hiring, compensating, and promoting nonfamily managers by altering the relative importance of economic and noneconomic goals, or the ability of the firm to economize on bounded rationality. Generally speaking, anything that increases (decreases) the relative importance of family owners' economic goals or decreases (increases) the importance of their noneconomic goals will mitigate (aggravate) the relationships discussed in this paper and reflected in our propositions.

For example, as Gómez-Mejía et al. (2007) note, later generation family firms are apt to be less concerned with socioemotional wealth than first-generation family firms, which should lessen the resistance to the involvement of nonfamily managers even though the size of the family unit may actually be larger as it moves into the sibling partnership or cousin consortium stage of development (Gersick, Davis, Hampton, & Lansberg, 1997). Similarly, Gomez-Mejia et al. (2010) have shown that when family owners perceive a threat to the viability of the firm, an increase in economic performance will provide more utility than will be lost by a decrease in noneconomic performance. This occurs because in the realm of losses, decision makers become risk-seeking rather than risk-averse (Kahneman, 2003). Thus, in contrast to the situations we have discussed herein, if family owners perceive that upholding the *status quo* of family management will result in a certain economic loss, the attractiveness of hiring and providing compensation to nonfamily managers should be positively related to the size of the anticipated loss.

With regard to bounded rationality, we assumed that managers were invariably stewards rather than potential agents. But as we have discussed, uncertainties associated with hiring nonfamily managers still exist in the absence of opportunism because signaling mechanisms are imperfect and employers cannot always distinguish between high- and low-quality managers (Akerlof, 1970; Burdett & Mortensen, 1981). Thus, in the decision to hire nonfamily managers, the problem with opportunistic behavior is that it exacerbates the asymmetric and imperfect information problems that already exist. In short, opportunism acts to further reduce the desirability of hiring nonfamily managers by increasing uncertainties and costs.

Conclusion

In this paper, we address the question of why, whenever possible, small- and medium-sized family firms tend to employ family members rather than nonfamily members as managers. The discussion also, of course, pertains to the preference of family firms to pursue intrafamily succession rather than professional management options (Stewart & Hitt, 2012). As we have shown, there are both economic and noneconomic reasons for the phenomenon, and these reasons are interrelated. The socioemotional value obtained through transgenerational family involvement and control is obviously a factor. What is less obvious is how noneconomic goals can influence the ability to hire high-quality nonfamily managers, as well as why hiring better qualified nonfamily managers will not necessarily enable family owners to obtain a level of firm performance that meets their expectations. To address this issue, we employ diminishing marginal utility theory to suggest that higher economic performance will usually increase utility only at a decreasing rate, whereas forfeiting noneconomic goals by employing nonfamily managers will decrease utility at an increasing rate in accordance with the importance of those goals. What this means is that in all probability, family owners will suffer the winner's curse—overpaying for a set of uncertain benefits—not because of opportunism on the part of managers but because of bounded rationality, along with a desire to counteract the loss of socioemotional wealth. As we have argued, the winner's curse can occur even if the performance of the family firm increases relative to what it had previously been under the direction of family managers. Furthermore, when this notion is combined with recognition of how the idiosyncrasies of family firms affect the bounded rationality of nonfamily managers, we are able to explain why hiring family managers often makes sense economically as well as noneconomically even if nonfamily managers behave as stewards rather than agents.

Our paper contributes to the literature by providing an economic analysis that more fully explains the motivations that influence the preferences of family owners with regard to the composition and compensation of the firm's management team. We show that the preference for family managers is a function of a complex set of factors, including economic and noneconomic goals, bounded rationality, labor market characteristics, and performance aspirations. Thus, while higher current wages for nonfamily managers could at least ameliorate the disadvantages of family firms in competing with nonfamily firms for high-quality, nonfamily managers, family firms are likely to be hesitant to pursue that course of action. We show that even if family firms are able to hire such managers, the potential for overbidding could cause the resulting economic performance to fall short of expectations. As we explain, overbidding is a consequence of bounded rationality—family owners cannot fully know the capabilities of nonfamily managers beforehand, and nonfamily managers cannot fully understand or contribute to the achievement of the noneconomic goals of family owners. Thus, even stewards are likely to be found wanting because family owners will desire to counteract the loss of noneconomic utility with greater economic utility, and consequently will expect a level of performance that is apt to exceed the capabilities of nonfamily managers, regardless of quality. In short, the concept of the “winner's curse” further explains why family owners may be reluctant and/or unable to professionalize the management structure of their firms, and why doing so may lead to less than satisfactory results. We also contribute to the literature by demonstrating that the adverse selection problems associated with family firms hiring nonfamily managers do not depend upon the application of agency theory (Burkart et al., 2002; Chua et al., 2009) or transaction cost theory (Lee et al., 2003; Pollak, 1985; Williamson, 1985), both of which assume the possibility of opportunism. Naturally, when opportunism is present in addition to information asymmetries, the situation we have described will become more severe. However, while opportunism may exacerbate the above-mentioned adverse selection problems that family firms face when hiring nonfamily managers, it is not required to demonstrate them because they are rooted in bounded rationality, not necessarily dysfunctional pursuit of self-interest. As a consequence, our analysis suggests that regardless of whether nonfamily managers behave as stewards or agents, there are still compelling reasons for family firms to hire family managers.

This contribution is of particular importance for two reasons. First, the bounded rationality associated with the family form of governance has not been fully considered in the literature. Yet the involvement of a mix of family and nonfamily members, the importance of noneconomic goals (Chrisman et al., 2012), and the propensity of family firms to follow idiosyncratic strategies (Carney, 2005) that are often dependent upon tacit knowledge (Gedajlovic & Carney, 2010) suggest that bounded rationality could be a more important problem in family firms than nonfamily firms. As Mitchell et al. (2003) suggest, overlaying family issues onto firm issues factorially increases the cognitions with which nonfamily employees must contend. We extend their work by arguing that these complexities apply to and influence the decision making of family owners as well. Simply put, how family firms economize on bounded rationality deserves more attention, a point that is emphasized by our treatment of hiring and compensation decisions.

Furthermore, by explicitly dealing with bounded rationality rather than both bounded rationality and opportunism, we were able to demonstrate that even if nonfamily managers behave as stewards, the problems of hiring and compensating nonfamily managers do not disappear because stewardship is only possible after an individual is hired, never before (Jensen & Meckling, 1994). Stewards will not necessarily subsume their self-interest when evaluating career opportunities, and bounded rationality can lead high-quality stewards to prefer nonfamily employers. Bounded rationality also creates uncertainties with regard to the characteristics and qualities of stewards as well as agents. It can make goal alignment and achievement difficult regardless of intentions. Thus, more work is needed to understand how bounded rationality influences the behavior of stewards. This is important because stewardship theory does not explicitly incorporate the implications of bounded rationality into its descriptions or predictions of behavior. For example, incorporating bounded rationality, not to mention bounded reliability (Verbeke & Greidanus, 2009), into stewardship theory would suggest that monitoring is still necessary to reduce the impact of imperfect and asymmetric information, even though it might not be needed to control aberrant behavior. Likewise, incentive systems may still be useful to signal priorities among multiple goals and reinforce the efficacy of desired behaviors. Because bounded rationality constrains the ability of all managers to make effective choices in the interests of owners, and indeed even to fully understand those interests, opportunism simply increases the need for monitoring and incentives rather than creating the need, as is commonly thought in the literature (e.g., Corbetta & Salvato, 2004). In fact, because they provide information, monitoring and incentive systems may actually be beneficial to nonfamily managers as well as family owners, if not taken to extremes.

Implications for Research

In terms of future research, the relationship between the composition and compensation of the management teams in family firms discussed in this paper deserves further study. Some family firms may eschew family-centered, noneconomic goals and seek to overcome the perceptions that their behavior is shaped in accordance with such goals. It would, therefore, be interesting to understand the signals that these family firms might use to build a reputation for professional management practices in order to avoid or nullify some of the problems described in this paper, as well as the effectiveness of those signals. Furthermore, although we suggest that small- and medium-sized family firms will usually need, but may not be willing, to pay nonfamily managers more than nonfamily firms to attract similar talent, research is needed to better understand the practices in which such firms actually engage and the outcomes of those practices. Whether, when, and which family firms will systematically underbid to avoid the problems discussed in this paper or overbid to obtain managers who are more capable than family managers is an empirical question, and of course depends in part on the relative value of achieving different goals, as well as the competitive situation. Research is needed to shed light on such issues which, as shown by our analysis, are much more complex than they might initially appear. For example, research on how family firms adjust their goals, strategies, or human resource policies to avoid the winner's curse is needed.

Implications for Practice

Our paper also contributes to practice by highlighting the importance of the precontractual stage of the hiring process of nonfamily managers in small- and medium-sized family firms. When formal monitoring systems and incentives are absent or insufficient, as is often the case in family firms (e.g., Chua et al., 2009), diligence at the precontractual stage of the employment of nonfamily managers becomes more important even if opportunism is not expected or forthcoming. Family firms may increase their odds of employing nonfamily managers who fit their needs if they are able to recognize and openly communicate their priorities during the selection process. Likewise, nonfamily managers need to attempt to communicate their needs and endeavor to understand and adapt to the priorities of family owners in order to increase the chance of a satisfying and successful employment experience. Thus, family owners and nonfamily managers need to appreciate that there will be some differences in their goals, and therefore the strategies that they believe are necessary to achieve those goals. Family and nonfamily stakeholders will be able to work together more easily and more effectively if both can exhibit tolerance toward the expanded goal set that will be required to meet their common and disparate needs (cf. Villanueva & Sapienza, 2009). Furthermore, the application of formal monitoring and incentive systems can help reduce information asymmetries, and lead to fairer and more satisfactory outcomes for family owners and nonfamily managers alike.

In conclusion, we use economic analysis focused on noneconomic goals, bounded rationality, and the winner's curse to enrich our understanding about why family owners favor family managers over nonfamily managers in small- and medium-sized family firms. We hope our exposition will shed new light on the problems facing family firms, and prompt further research on their decisions, behaviors, and performance.

Footnotes

1. Family firms are defined by a family's involvement in ownership and governance, and a vision for how the firm will benefit the family, potentially across generations (Bennedsen, Perez-Gonzalez, & Wolfenzon, 2010; Chua, Chrisman, & Sharma, 1999).

2. Family-centered, noneconomic goals are closely tied to the socioemotional wealth of the firm, and therefore include a variety of objectives specifically related to desirable nonpecuniary aspects of firm ownership, such as control and influence, identification, social ties, emotional attachment, and firm renewal through transgenerational family

succession (Berrone, Cruz, & Gomez-Mejia, 2012). Differences in the relative weights attached to these goals could influence the relationships described in this paper.

3. Managers are defined as the key decision makers in a firm (Eisenhardt, 1999; Shrivastava & Grant, 1985).

4. A lemons problem occurs when it is difficult to distinguish good and bad quality prior to use or employment, and asymmetric information about quality exists between buyers and sellers, employers and employees, etc.

5. Although there may be specific instances where nonfamily managers can contribute to noneconomic goal achievement, the difficulties in articulating, communicating, and measuring such goals place limits on their ability to do so. Thus, bounded rationality, as well as nonfamily status, can constrain the ability of stewards to contribute to the achievement of the noneconomic goals of family firms (Chua et al., 2009; Davis et al., 1997).

6. Verbeke and Greidanus (2009) introduce the concept of bounded reliability and note that in addition to opportunism, failed commitments among individuals can occur from benevolent preference reversals associated with reprioritization and over-commitment. Since these can lead to the same outcomes as opportunistic behavior, we do not deal with them in this paper. However, it is important to note that although stewards will not be opportunistic, both stewards and agents can be boundedly reliable as well as boundedly rational (Verbeke & Kano, 2010, 2012).

7. Some of the disadvantage of family firms might be offset if they provided better career training (cf. Miyazaki, 1977); unfortunately, evidence suggests that the training offered to nonfamily managers in family firms is inferior to the training offered in nonfamily firms (Gedajlovic & Carney, 2010; Reid & Adams, 2001), which may be related to their reluctance to professionalize (Stewart & Hitt, 2012) and tendency to undervalue their nonfamily labor force (Verbeke & Kano, 2010, 2012).

8. Although the loss of utility is presumed to occur to a lesser extent if there are no family managers available, some loss could still occur since the desire to maintain family control is likely to remain; just because people cannot always get what they want does not necessarily mean they no longer want it or do not feel the loss. Evidence of this comes from the observed use of a “seat-warmer strategy” involving the appointment of interim nonfamily managers until qualified (albeit potentially less capable) family members become available (Lee et al., 2003).

9. However, it is possible that the contributions to the economic goals of the family firm by nonfamily managers could also contribute to its noneconomic goals (Zellweger & Nason, 2008). Examples include managerial actions that improve firm performance and generate social capital or enhance the reputation of both the firm and family.

10. Furthermore, if the gap in the wages (and therefore total compensation) offered by family and nonfamily firms increases, the sorting problem discussed above could be expected to get worse, whether family firms attempt to offset wage differentials through nonpecuniary benefits or not. Consequently, the average quality of the pool of nonfamily managers available to family firms should decline as competition for managers increases.

11. However, as suggested earlier, there may be circumstances when the achievement of economic and noneconomic goals are compatible such as when they both require a favorable reputation for the firm (Zellweger & Nason, 2008).

12. The unrealistic and unfulfilled expectations that characterize the winner's curse can also occur when hiring family managers. Thus, family owners will expect family managers to contribute to the fulfillment of noneconomic goals as well as economic goals, although perhaps more to the former than the latter. However, family managers frequently do not deliver on either expectation (cf. Schulze et al., 2001). Indeed, the well-known and recurrent conflict between family incumbents and family successors documented in the literature (e.g., Kellermanns & Eddleston, 2004) suggests that the bundle of noneconomic and economic utilities expected from hiring family managers may not always materialize.

13. Shifting from one family firm to another will not *necessarily* eliminate the problem because the variety of economic and noneconomic goals that family firms follow suggests that their strategies could be as different, if not more different, from each other as they are from the strategies of nonfamily firms (Chrisman & Patel, 2012).

14. Here, it is important to point out that higher wages expand the labor pool but not the ability of an individual manager. Furthermore, because managers are presumed stewards rather than agents, higher wages will not coax additional effort out of those managers. Finally, bounded rationality applies to stewards just as much as it does to agents.

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This work was supported by a grant from the Family Owned Business Institute. The authors thank Jess Chua, Hanqing Fang, Daniel Holt, Franz Kellermanns, Allison Pearson, Chris Penney, ETP Editor Don Neubaum, and two anonymous reviewers for their comments on earlier drafts of this article.